Economic Overview.

Around we go again.

August 2019

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Storm clouds have gathered over the global economy, and New Zealand is getting caught in the downdraught. We expect the situation to get worse before it gets better, as the escalating US-China trade war makes its mark on global economic growth. We've slashed our 2020 annual GDP forecast for New Zealand from 3.1% to 2.3%, and we expect unemployment will soon rise.

The Reserve Bank is riding to the rescue, and in this *Economic Overview* we argue that it will be effective. Mortgage rates have tumbled, and if further stimulus is required the Reserve Bank has options. We expect tumbling interest rates will spur asset prices, including an acceleration in house price inflation from around 1% now to 7% next year. Combined with expanding government spending, that will shore up GDP growth.

But propping up growth in this manner will deepen the long-term risks in the economy. New Zealand is locked in a cycle of economic growth driven by ever lower interest rates causing ever higher asset prices, facilitated by ever increasing household debt. This cycle can't last forever, and when it ends things could turn ugly. One possibility is that right now we are seeing the "beginning of the end". That's a risk but it is not my central view, because I think monetary policy is going to work.

Things are more likely to come to a head when interest rates rise. There are a range of possible catalysts for that, but historically inflation has been the party pooper. I can't see inflation ramping up any time soon, and that's why we are forecasting another turn of the merry-go-round over the coming year or two. But the ride will stop eventually – further in the future, we are forecasting a period of rising inflation, higher interest rates, falling house prices and a downturn in GDP growth.

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New Zealand Economy.

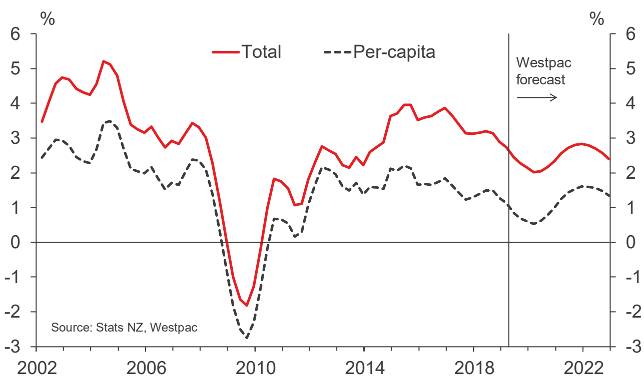
Once more with feeling.

The New Zealand economy has slowed, and the situation is likely to deteriorate further in the short term. We expect a recovery over 2020 and 2021 on the back of government spending and lower interest rates. This would be another round of growth underpinned by rising asset prices and higher debt. The resulting build-up of risk is a dark cloud on the economic horizon.

Shifting down a gear

The New Zealand economy has continued to soften. After expanding at rates of over 3% through 2018, annual GDP growth has slowed to 2.7% in the early part of this year. Adjusting for population changes, annual per capita growth has now fallen to just 1.1% – its slowest pace in eight years.

Figure 1: Total and per capita GDP growth



Regular readers will know that we predicted the slowdown in economic growth that has occurred since 2016. We had previously highlighted that the Canterbury rebuild would gradually wind down, net migration would slow, and the cooling housing market would dampen household spending. All of that has come to pass, and the resulting weakness in demand has been a significant drag on GDP growth over the past year.

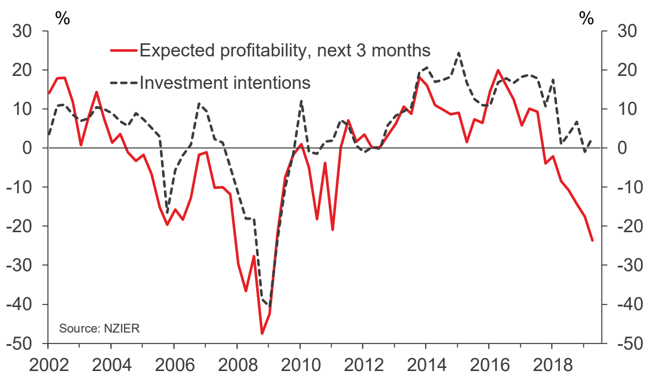
However, we had expected to see the economy turning around in mid-2019, due to low interest rates and increases in government spending. Instead, activity has remained subdued, with recent indicators pointing to quarterly GDP growth of only around 0.5% through the second half of 2019.

The big change since our last *Economic Overview* has been the state of the global economy. As discussed in the *Global Economy* section, the US-China trade war has intensified, and the impacts are being felt in some of our key export industries: international visitor numbers are down 3%; our forecast for the milk price payout has dropped from strong to average levels; and export log prices have fallen around 25%.

Tumbling log prices are a particularly worrying development. When forestry prices drop some forest owners, especially smaller ones, stop harvesting. That results in a double whammy for the economy with a hit to both incomes and activity. Using the 2014 forestry downturn as a guide, we estimate that log export volumes will fall by 10% and around 700 forestry and logging jobs could be lost. The impact on regional economies could be even larger as the downturn spills over into demand for associated services like transport. The east coast of the North Island, Northland, Tasman/Nelson, and Southland are likely to be especially hard hit.

This weakening in the external environment has reinforced the sense of nervousness already present in many corners of the domestic economy. Business confidence has been low since the 2017 election, and it's fallen even further in recent months. Businesses are reporting tough trading conditions, including strong competition, rising costs and sluggish demand. That's seen margins squeezed and plans for investment spending wound back.

Figure 2: Surveyed profitability and investment intentions



To date, the labour market has been resilient to the downturn in the business sector, with unemployment falling to just

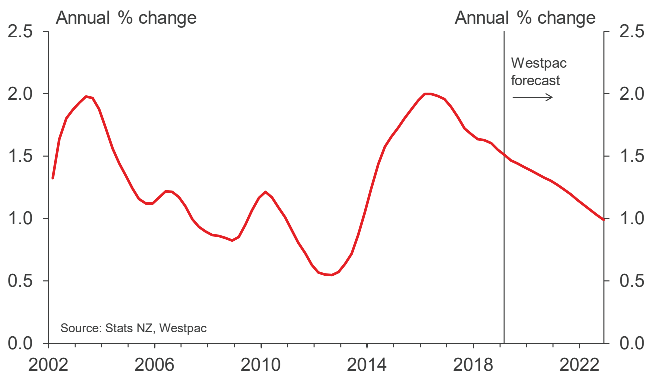
3.9% in June. However, there are signs that hiring has now started to slow, with employment intentions and the number of job advertisements falling in recent months. We expect that unemployment will push back up to 4.2% by the end of this year.

Turning to the household sector, we are at long last seeing signs that income growth is accelerating. Over the past year, base wage rates in the private sector rose by 2.2%, the largest annual increase in a decade. Wage growth has been boosted by the large 7.3% increase in the minimum wage that took effect in April. And on top of that, there has also been a more general firming in wages, as well as solid jobs growth over the past year.

Despite the firming in the labour market, household demand has been subdued, with retail spending essentially flat since January. We expect spending growth will remain muted through the remainder of this year. In part, this is due to ongoing weakness in housing markets in some parts of the country. High petrol prices are also continuing to constrain spending, offsetting some of the increases in transfer payments like Working for Families.

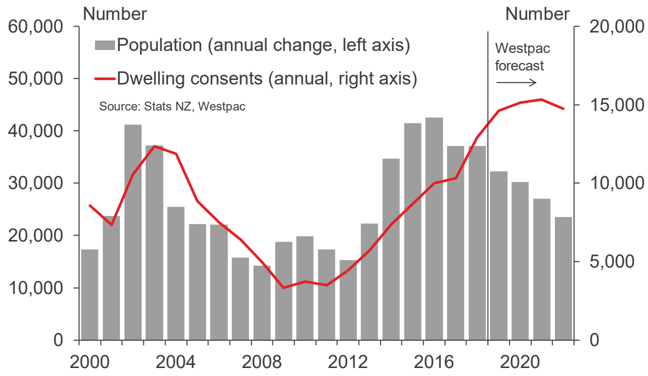
Reinforcing the sluggishness in spending and economic conditions more generally has been the continuing slowdown in net migration and population growth. After peaking at just over 2% in 2016, annual population growth has now slowed to around 1.6%, and we expect that it will continue to decline over the next few years. This will remove an 'easy' source of demand growth that many businesses have enjoyed in recent years. It will also have important implications for the housing and labour markets.

Figure 3: New Zealand population growth



The bright spot in the economy has been the construction sector. Residential building is booming, especially in Auckland where consent issuance has risen to a record high. There is also a large pipeline of commercial and infrastructure projects planned nationwide. However, with post-earthquake construction winding down and population growth slowing, we expect that nationwide construction activity will peak in 2020, and gradually ease back thereafter.

Figure 4: Population and residential building – Auckland



Monetary and fiscal policy come to the party… and spike the punch

With the economy losing momentum, the Reserve Bank has already cut the Official Cash Rate (OCR) to a record low, and we think there is still more to come. On top of that, we expect a significant spend up from the Government over the coming years. The resulting cocktail of monetary and fiscal stimulus will be a powerful boost to demand. We expect that this will result in GDP growth accelerating to 2.3% in 2020, rising to 2.8% in 2021.

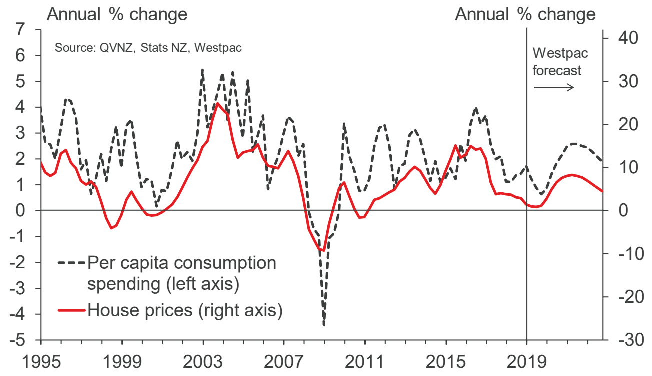
The RBNZ's 'lower for longer' stance has helped to put a lid on the exchange rate, which has been a welcome relief for exporters. But the major impact low interest rates will have is via asset markets. New Zealand has already entered a 'search for yield' environment, with investors shunning bank deposits in favour of assets that have the potential for higher returns or capital gains. Share prices in particular are through the roof. We think it's only a matter of time before investors turn their eye back to New Zealanders' favourite form of savings – houses.

With fixed mortgage rates down, and plans for a capital gains tax now shelved, we expect house price inflation will rise from around 1% now to around 7% per annum for the next two years. Relative to previous housing market upswings, that's still a fairly modest lift, with policy changes such as the foreign buyer ban and the introduction of ring-fencing likely to limit price growth to some extent.

We expect that the pickup in the housing market will become increasingly evident over the coming year. But even at this early stage, we are already seeing some straws in the wind supporting our forecast. That includes a pick-up in seasonally adjusted house sales in areas like Auckland, as well as a reduction in the number of unsold homes.

This rise in house prices will be very important for economic conditions more generally. New Zealanders hold the bulk of their wealth in housing assets, and rising house price growth is likely to support a related lift in household confidence and spending.

Figure 5: House prices and household spending

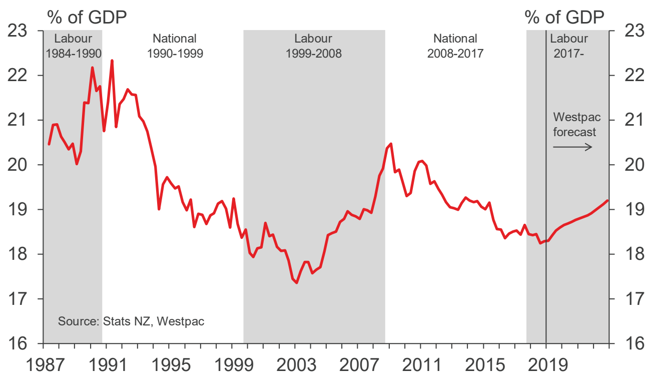


The slowdown in the economy has also resulted in a growing chorus of voices – including the RBNZ – calling for increases in government spending. We're circumspect about such suggestions as fiscal policy tends to be relatively ineffective for managing short-term ups and downs in economic activity. But we do have to admit that low interest rates have shifted the calculus in favour of government borrowing and spending.

With the 2020 election coming into sight, we are forecasting that the Government will introduce plans for around $1bn per annum of additional spending at each Budget. That's in addition to the more than $8bn of new spending that has already been announced since the 2017 election. This additional spending will be a mix of higher transfer payments, pay rises for public sector employees, and some boost to health and education services.

Even with these large increases in spending, we still expect that the Government will continue to run small surpluses, ensuring that this additional expenditure is politically palatable.

Figure 6: Government consumption share of GDP



Stop me if you've heard this one before

Our forecasts imply that New Zealand is going to experience another iteration of a very familiar cycle. The economy has gone through repeated episodes of falling interest rates that spark rising asset prices, which in turn boost economic growth. The facilitator is ever-increasing debt. This cycle cannot last forever. When asset prices and debt levels eventually stabilise or fall, things could turn ugly. The difficulty is pinpointing when that might happen.

One possibility is that the current headwinds from offshore and low confidence domestically might create an economic downdraught that is too strong for interest rates to counter, sending us into a tailspin of falling asset prices. That's a risk. But such a scenario could only really play out if monetary policy was not sufficiently powerful, and we don't believe that is the case. Both the *RBNZ and Interest Rates* section and the *Special Topic* strongly argue that the Reserve Bank is still capable of having a powerful influence on the economy.

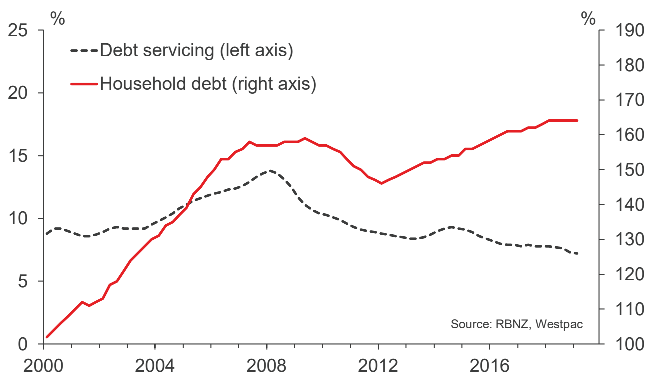
The RBNZ is capable of digging the economy out of its current hole, but it will do so by encouraging borrowing and spending at the expense of saving. Consequently, household debt will increase further as a proportion of GDP. What makes today's high debt levels sustainable for households is low interest rates. Figure 7 shows that even with the bloated debt levels they are carrying, households' interest servicing costs are low by historical standards.

But if interest rates increase it could be a different story. Debt servicing costs would rise, crimping household disposable income. At the same time, asset prices could fall, which would weaken household balance sheets. The consequence would be sharply lower household spending, and consequently lower economic growth.

There are a range of possible catalysts for higher interest rates, including a credit crunch. But the most plausible is inflation. Indeed, it was rising inflation that caused central banks to lift interest rates prior to the GFC. That skewered overextended borrowers and caused house prices to decline, setting off a chain of events that led to crisis.

But as the *Inflation* section emphasises, we see absolutely no sign of rising inflation rising in the near term, and hence we think interest rates will stay low for a long time. That is why we are forecasting another turn of the merry-go-round, with growth underpinned by rising asset prices and rising debt. But we do think that interest rates will eventually rise, which is why during the mid-2020s we are forecasting a period of falling house prices and a downturn in economic growth.

Figure 7: Household debt and debt servicing, % of household disposable income



Global Economy.

A white knuckle ride.

Trade tensions have ratcheted up in recent months and now look likely to persist for longer than we had previously assumed. In response, we have revised down our GDP growth forecasts for both China and the US. Central banks have responded to recent developments by aggressively cutting interest rates and further rate cuts are likely. Lower interest rates will stoke asset price growth and bolster the growth outlook. But this now familiar cycle can't continue indefinitely.

The US-China trade war has escalated significantly since the May *Economic Overview*. President Trump's tweet announcing his intention to slap a 10% tariff on the $300bn of Chinese imports that until now had been unaffected by tariff hikes has switched the warning lights on global growth from amber to red. We have lowered our forecast for GDP growth in China next year to 5.8% from 6% previously, and conditions may even feel materially weaker than this. GDP growth in the US is also expected to slow, from 2.3% this year to just 1.7% next year.

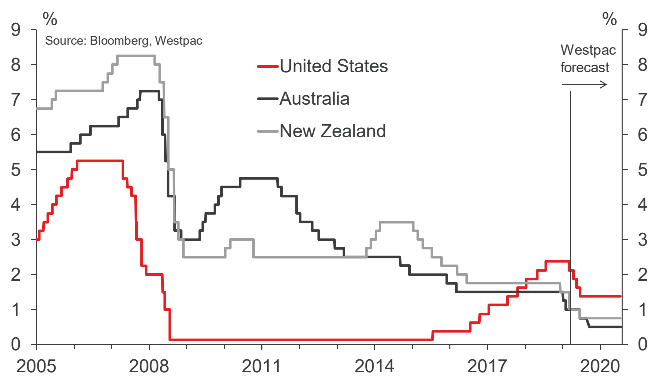
The latest tariff increases will put households in the firing line.

The latest tariff increases are expected to put US households directly in the firing line by lifting the cost of everyday consumer goods. While there has been some to and fro on when higher tariffs will be implemented, this only underscores the wider problems caused by the tariff war. With President Trump frequently surprising with tweets announcing trade policy changes, the outlook remains very uncertain and the conflict much more open ended than we had previously envisioned. This is weighing on business confidence. Not only will the latest moves directly impact households – a sector that has been, until now, a pillar of strength for the US economy – weaker confidence and an uncertain outlook may further depress business investment, hiring and wage growth. This will broaden the impact of the trade war which has already seen activity in the manufacturing sector slow sharply.

China has responded to the latest move from the US by firing back with both barrels, allowing the yuan to depreciate through key levels against the US dollar. A weaker yuan will offset some of the impact of the US tariffs, but it will also make imports more expensive for Chinese consumers and firms, crimping demand. Countries with very large trade exposures to China or who compete directly with Chinese-made goods in international markets will also struggle with a weaker yuan. All in all, while the weaker yuan should benefit Chinese exporters, it is also likely to exacerbate the negative impact from the trade war on global growth.

The escalation of the trade dispute has seen central banks around the world riding to the rescue. Since the May *Economic Overview*, we've seen the first rate cut from the Fed in a decade, two rate cuts from the Reserve Bank of Australia, as well as lower policy rates in a host of Asian economies including the likes of India, Thailand, Indonesia and South Korea.

Figure 8: Central bank policy rates



The Fed is likely to cut three more times this year as it works to offset the negative impact of the Trump tariffs on the US economy. In contrast, the contribution of US fiscal policy, which has been a key support to growth in recent years, is set to wane. The recent agreement between the Trump administration and Congress is enough to sustain the level of fiscal spending through to 2021, but does not allow for further increases.

The Fed is likely to cut three more times this year.

China is implementing measures designed to mitigate the impact of the trade war on the domestic economy. This has included measures to increase the availability of credit, tax cuts and incentives to increase infrastructure investment.

The RBA is also expected to continue its easing cycle by cutting its cash rate by another 25 basis points in November with a follow-up expected in February 2020. This would leave its policy rate at 0.5% – a level where interest rates could conceivably start to be complemented by alternative monetary policy instruments. Indeed, RBA Governor Lowe has already called for the Australian Government to support the RBA's efforts to stimulate the economy via a lift in fiscal spending, including investment in infrastructure.

We have entered a global "search for yield" environment.

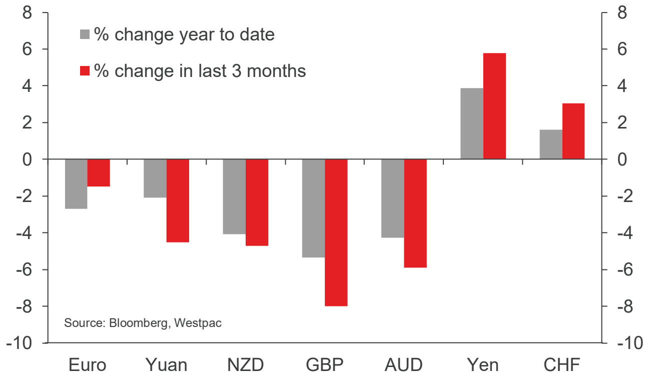
The recent sharp falls in global interest rates will, however, have consequences. Lower interest rates have spurred another lift in asset prices. There has been a strong increase in equity markets this year as lower interest rates have trumped growing fears about the pace for global growth. In China, ample credit growth has stoked higher house prices. And even Australia's housing market has responded to monetary stimulus. We expect the global monetary easing to shore up growth, but not until the latter part of next year.

Figure 9: International equity indices

Global monetary easing will create a race to the bottom in exchange rates.

The global monetary easing is also creating a "race to the bottom" for exchange rates. Given the concurrent easing cycle now underway, not participating means running the risk of being left high and dry against the outgoing global interest rate tide. If a country fails to lower their interest rates, their exchange rate would come under upward pressure, in turn damaging their economy and suppressing inflation which is already too low in most countries.

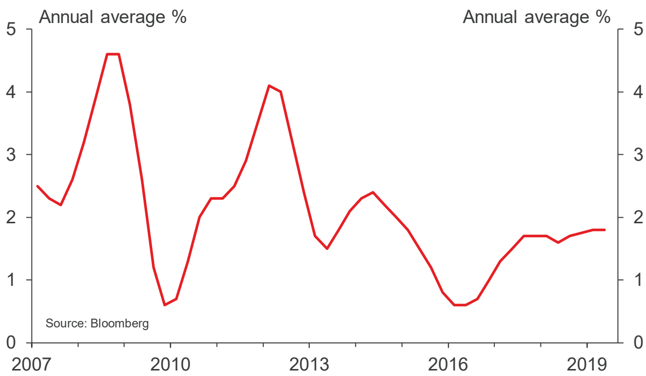
Figure 10: Selected currencies, change against the US dollar



Of course, there's always the risk that we're wrong and the downward momentum in the global economy is not sufficiently offset by interest rate cuts from central banks. Fiscal stimulus could also be slow to come to the rescue with Government debt in many countries still elevated following the GFC. This could see the downturn become more severe or long lasting than we are currently anticipating.

Although a risk, we don't view this as the most likely outcome. Most central banks should still have plenty of ammunition left. However, they can only keep interest rates low if the inflation outlook remains benign. For now, this looks likely with slowing demand and technological change reducing the pricing power of firms and allowing delivery of services directly to consumers at much lower cost. But if the current trade war leads to a disruption in global value chains that arrests the long-running trend of declining manufactured goods prices, inflation could start to rise. That would force a response from central banks which would leave the global economy in a much stickier situation than we have found ourselves in to date.

Figure 11: Average inflation in New Zealand trading partners



Inflation.

Stuck in a groove.

The outlook for inflation in New Zealand has an awfully familiar feel. Consumer price inflation has risen from its lows, but so far has lacked the impetus to reach the midpoint of the Reserve Bank's target band on a sustained basis. With global trends not doing much to generate price pressures, stronger domestic demand will need to play the dominant role.

Over the past three years New Zealand's inflation rate has held within a narrow range between 1.1% and 2.2%. That represents an improvement on previous years, when inflation was persistently below the lower end of the Reserve Bank's 1-3% target range. Gyrations in world oil prices accounted for much of the variance in inflation over that time, but a strengthening in the local economy and a decline in the exchange rate have also helped to lift inflation.

Still, a sustained return to the middle of the target range remains elusive. The headline inflation rate rose to 1.7% in the June quarter, but a subsequent pullback in fuel prices makes it likely that inflation will dip lower again over the second half of this year. But if we set aside the more volatile elements of the CPI, the picture looks similar. Core inflation – based on the RBNZ's estimates – has picked up from its lows, but has held at around 1.7% in recent quarters rather than heading higher.

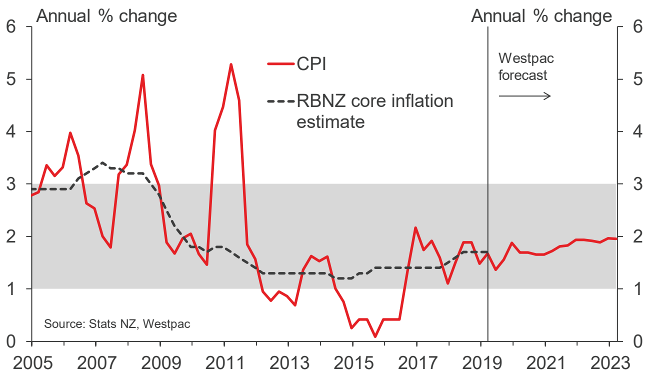
Our view remains that inflation will be slow to rise to the 2% midpoint, with global forces providing lingering headwinds. Technological developments are reshaping the retail environment worldwide, increasing competitive pressures and putting downward pressure on retail margins. And as we explain in the *Global Economy* section, we are also now looking at slower world growth and lower commodity prices, which will mean even less imported inflation for New Zealand.

A fall in the exchange rate helped to lift tradables inflation over 2017 and 2018. But that effect has since faded, with the New Zealand dollar broadly flat over the past year. As we note in the *Exchange Rates* section, we expect only a modest fall in the exchange rate from here, which will further limit the extent of imported inflation.

Instead, stronger domestic demand will be required to generate 2% inflation. Locally generated price pressures have picked up to some degree as spare capacity in the economy has been used up and wages have risen. However, progress has been slow, and the recent softening in economic growth could present a setback to this trend. Construction cost inflation appears to have passed its peak as the housing market has cooled, and government charges are not rising as rapidly as they have in the past.

Although our short-term view is that inflation will remain low, over a longer horizon we still expect the RBNZ to engineer a higher inflation rate. Under its new 'dual mandate' of maximum sustainable employment as well as inflation, the RBNZ is likely to be more accommodating of higher inflation outcomes once they do occur. Consequently, we expect that both actual and expected inflation will be allowed to drift above 2% over the longer term.

Figure 12: Consumer price inflation



Financial market forecasts (end of quarter)

	CPI inflation	OCR	90-day bill	2 year swap	5 year swap
Sep-19	1.4	1.00	1.00	0.90	1.10
Dec-19	1.6	0.75	0.90	0.80	1.00
Mar-20	1.9	0.75	0.90	0.80	1.00
Jun-20	1.7	0.75	0.90	0.80	1.05
Sep-20	1.7	0.75	0.90	0.85	1.10
Dec-20	1.7	0.75	0.90	0.90	1.15
Mar-21	1.7	0.75	0.90	0.95	1.20
Jun-21	1.7	0.75	0.90	1.00	1.25
Sep-21	1.8	0.75	0.90	1.05	1.30
Dec-21	1.8	0.75	0.90	1.10	1.40

The Reserve Bank and Interest Rates.

You had me at point seven five.

The RBNZ's current attempt to woo the economy with a lower OCR looks likely to prove successful, because the RBNZ has engineered a very sharp reduction in mortgage rates. If the economy did require further stimulus, the RBNZ would find it harder, but not impossible, to arrange another reduction in retail lending rates.

Since our last *Economic Overview* the economic backdrop has clearly worsened, so it is no surprise that the Reserve Bank has lowered interest rates. What was surprising was the RBNZ's execution. At the June OCR Review the RBNZ kept the OCR on hold but warned that cuts might lie ahead. Then in August the RBNZ cut the OCR 50 basis points instead of the usual 25, arguing that any stimulus should be delivered up front rather than waiting.

This behaviour has taught us two things. First, the RBNZ is more likely to shift the OCR at *Monetary Policy Statements* (MPS), which feature full statements on monetary policy. Major changes at OCR Reviews, which are accompanied by only a short press release, are less likely. Second, we have received another salutary reminder that the "new" RBNZ is extremely proactive and aggressive, at least in response to downside developments.

With these lessons in mind, we are now forecasting that the RBNZ will leave the OCR on hold at the September OCR Review, but will cut it to 0.75% at the November MPS. As explained earlier in this document, we expect the economic backdrop to worsen over the coming month or two, both globally and in New Zealand. Importantly, we expect GDP growth to fall short of the RBNZ's near-term forecasts, which are 0.6% and 0.7% for the coming two quarters.

Like a suitor proffering roses, the RBNZ is attempting to woo the economy with a lower OCR. The question is whether the economy will respond favourably or rebuff the RBNZ's advances. To date, monetary policy has been very effective at getting mortgage rates down. The *New Zealand Economy* section made it clear that we expect this to cause higher asset prices, with flow-on effects to the economy and inflation. Given the success of the stimulus delivered so far, we don't expect that the OCR will need to go below 0.75%.

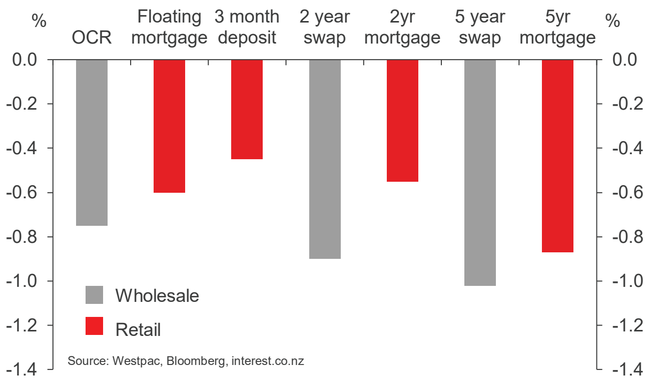
But if something unexpected happened and another round of stimulus was required, the RBNZ would have to work harder to achieve the same degree of stimulus. The nub of the matter is how much deposit and lending rates in the economy will fall in response to OCR cuts. Transactional accounts at banks already pay zero interest and can't be reduced further. This means that as the OCR falls, the average interest rate banks pay on deposits is not falling one-for-one with the OCR.

Therefore banks won't reduce lending rates one-for-one with the OCR. Figure 13 illustrates that, to date, retail interest rates have not fallen as far as equivalent wholesale rates. Nevertheless, the RBNZ has engineered a very sharp reduction in key fixed mortgage rates via the powerful influence it has had on longer-dated swap rates.

It would be difficult for the RBNZ to repeat this feat of interest rate reduction. If the RBNZ was to reduce the OCR further swap rates would fall, but not as readily as in recent months. Secondly, the passthrough from swap rates to mortgage rates will get blunter the closer the OCR gets to zero.

Another potential issue is the possibility that banks will refuse to lower deposit rates lest savers withdraw their money and banks run out of funds. On this we are less concerned – it has not happened in countries with much lower interest rates than New Zealand. At present, the global search for yield environment means there is ample wholesale funding available to banks. And in any case, short of stuffing cash under the mattress there is not really anywhere New Zealanders' collective deposits can flee. If one erstwhile saver withdraws her cash to purchase an asset, the seller will most likely deposit the proceeds at a bank. Indeed, an environment in which people eschew bank deposits in favour of putting their money to work is exactly what the Reserve Bank would like to engineer – it would be far worse if people stuck with bank deposits out of fear despite low interest rates.

Figure 13: Change in NZ interest rates, 15 March to 15 August



Agricultural Outlook.

Storm clouds brewing.

The outlook for New Zealand's export commodity prices has darkened in recent months as the trade war between China and the US has escalated and Chinese consumers have been dragged into the fray. Log prices plunged in July and dairy prices have continued their downward slide. Meat prices, however, look set to buck this trend as Chinese consumers continue to seek pork alternatives.

In recent months the US-China trade war has escalated dramatically. The latest developments will impact consumers in both countries and slow global growth. Consequently, prospects for New Zealand's primary exports have darkened.

The trade war has already made itself felt with a 25% drop in log export prices in July. Chinese demand has weakened, in part due to weaker exports of goods such as furniture on the back of the US tariffs. This has coincided with strong supply of wood coming from Europe to send prices tumbling. The recent sharp drop in prices will make harvesting an uneconomic proposition for some forest owners, and over time this should reduce supply and support prices. However, prices are likely to fall further before a recovery begins.

Like logs, New Zealand wool is often an input into manufactured goods such as carpets and furnishings. Anecdotally, Chinese demand for wool has been weak in recent auctions, and prices for coarse wool continue to linger at low levels, with little prospect of near term improvement.

The fortunes of New Zealand food commodity producers are much more closely tied to Chinese household demand. Here the news is more mixed. We expect global dairy prices to fall in the coming months. Although growth in global milk supply has been modest, recent developments suggest the outlook for Chinese consumer demand has deteriorated. The weaker yuan will make imports more expensive and locally produced Chinese products more competitive, complementing policy makers' longer-term objectives of increasing domestic agricultural production. And while China's decision to halt purchases of US agricultural products will have reverberations, we think these will be swamped by the weaker global growth outlook. Add to this the 8% fall in dairy prices we've seen since May and we are now forecasting a $6.50 farm gate milk price for this season.

In contrast, beef and lamb prices have been bolstered in recent months by very strong Chinese demand as the country struggles to cope with an ongoing outbreak of African swine fever (ASF). While it is difficult to know the true impact of the outbreak, it's estimated that the disease could cut pork production in China (home to around half the world's pigs) by up to a third. This will push prices up and force some consumers to substitute pork with alternatives such as beef and lamb. What's more, this comes at a time when global lamb supplies are tight.

Commodity price monitor

Sector	Trend	Current level[1]	Next 6 months
Forestry	We expect further falls in export log prices as the US-China trade war continues to weigh on manufacturing activity in China. Locally, prices have been more stable, with demand underpinned by ongoing strength in residential construction.	Above average	↓
Wool	Prices have remained low due to weak demand from China.	Average	↘
Dairy	Prices have been sliding since May despite expectations for only modest growth in global milk supply this year. We expect Chinese demand to slow in the coming months, reducing prices further. We have revised down our milk price forecast for the 2019/20 season to $6.50. Fonterra's decision not to pay a dividend for the 2018/19 season is also a negative for farmer cash flows.	Average	↘
Lamb	Strong Chinese demand and tight global supplies continue to support prices. We expect this to continue as Chinese consumers look for pork alternatives due to ASF.	High	→
Beef	ASF is expected to support prices, despite the trade war impact on Chinese consumers.	High	→
Horticulture	The sector continues to enjoy a strong run as it reaps the rewards of investment in new varieties of fruit. However, prices could fall due to slowing economic growth in Asia.	High	↘

[1] NZ dollar prices adjusted for inflation, deviation from 10 year average.

Exchange Rates.

Race to the bottom.

The New Zealand dollar has fallen against the US dollar, broadly in line with our forecasts. We've lowered our New Zealand dollar forecasts for the rest of this year and next, based on our expectation of a softer domestic economy in the near term, lower export commodity prices, and a more drawn-out period of low interest rates.

The increasingly gloomy sentiment about the world economy has made its mark on foreign exchange markets. With interest rates around the world falling in tandem, there's been less to distinguish currencies in terms of the relative yields that they offer. However, bouts of 'risk-off' sentiment have led to substantial short-term volatility.

The one consistent trend in recent months has been a strengthening of the US dollar, which has benefited from the US being seen as both one of the best-performing developed economies, and as a safe-haven amid global uncertainty (despite US policy being a major source of that uncertainty). On a broad index, the US dollar is nearing the all-time highs that it reached in 2002, and we expect that it will extend its gains into next year.

The New Zealand dollar's performance has been more mixed. In our May *Economic Overview* we predicted that the NZD would fall to 0.64 against the US dollar over the September quarter. That target is now close to being met, but it's been a bumpy ride along the way. The currency rose from 0.65 to 0.68 between June and July before dropping back again, and more recently, the RBNZ's sharp change of tack has helped to push it down further.

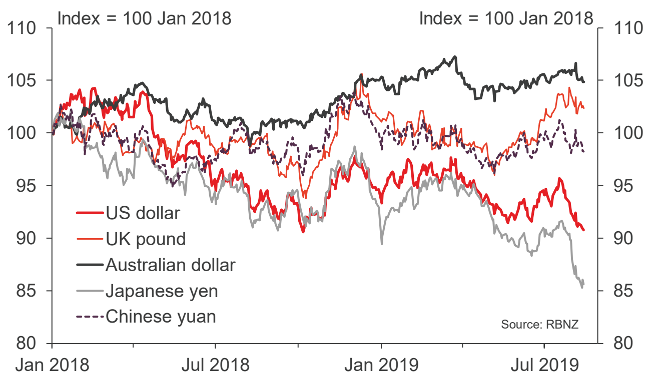
We now expect a further modest decline to 0.63 by early next year. Local economic data is likely to remain soft in the near term. However, the market has already more than fully priced in another rate cut by the RBNZ, limiting the potential downside for the currency. We have lowered our end-2020 forecast from 0.67 to 0.64, as the prospect of a rise in interest rates is looking more distant.

In May we expected the NZD to strengthen against the Australian dollar on the basis of a relatively stronger New Zealand economy and a divergence in the two countries' monetary policy cycles. The NZD/AUD actually rose by even more than we expected, at least up until the RBNZ's surprise 50 basis point rate cut. But now that the RBNZ is cutting at least as vigorously as the RBA, the outlook has changed. We now see these two currencies on more of a level pegging over the next year.

In terms of the other major currencies, we expect the NZD to appreciate relative to the Chinese yuan and British pound in the near term. In response to the escalating trade war with the US, China has allowed the yuan to fall below what was previously considered to be its 'line in the sand'. With tensions likely to persist for some time, we expect to see a further decline in the yuan in coming months.

The British pound has been under renewed pressure due to growing fears of a no-deal Brexit at the end of October. Our forecasts assume some sort of resolution by then, but the risks are clearly towards a more severe outcome.

Figure 14: NZ dollar exchange rates vs major countries



Exchange rate forecasts (end of quarter)

	NZD/ USD	NZD/ AUD	NZD/ EUR	NZD/ GBP	NZD/ JPY	TWI
Sep-19	0.64	0.96	0.59	0.54	67.8	71.9
Dec-19	0.64	0.96	0.59	0.54	67.8	72.2
Mar-20	0.63	0.95	0.58	0.53	67.4	71.4
Jun-20	0.63	0.95	0.58	0.52	68.0	71.0
Sep-20	0.64	0.96	0.59	0.52	70.4	71.6
Dec-20	0.64	0.96	0.58	0.51	71.0	71.1
Mar-21	0.65	0.96	0.58	0.50	71.5	71.4
Jun-21	0.66	0.95	0.58	0.50	72.1	71.4
Sep-21	0.66	0.93	0.58	0.50	72.3	71.5
Dec-21	0.67	0.93	0.58	0.50	73.0	71.7

Special Topic.

What happens if the OCR reaches zero?

We think 0.75% is as low as the OCR will need to go, but what would happen if more monetary stimulus was needed after that? Here we detail the RBNZ's options for unconventional monetary policy, such as negative interest rates and quantitative easing. These policies are perfectly capable of generating inflation if used with sufficient vigour.

If the OCR was to reach zero the RBNZ would have a range of options for injecting further monetary stimulus, including negative interest rates, large-scale asset purchases, and targeted funding for banks. Recent RBNZ comments indicate that the first cab off the rank would be a negative OCR. Other unconventional monetary policy measures would kick in only once the OCR had reached -0.5% or so.

The banking system as a whole is required to hold reserves at the RBNZ. In normal times, banks receive a positive interest rate on these reserves, at a margin slightly below the OCR. This sets a benchmark for the interest rates at which banks will be prepared to lend, and for what they are willing to pay to attract deposits.

Setting the OCR below zero means that holding reserves would become a cost for banks. That creates an incentive for banks to circulate this money faster by lending it out – and to encourage more borrowing, they will need to reduce their lending rates.

Overseas experience suggests that the OCR can't go much below zero before it loses traction. Banks have been reluctant to offer negative deposit rates, due to concerns that people might hoard physical cash instead. In turn, that has limited their ability to reduce interest rates for borrowers. In Europe, where bank profitability was already weak, some banks have perversely increased their mortgage rates in order to recoup the cost of holding reserves at negative interest rates.

It's not clear where the effective lower bound would be in New Zealand, but we suspect that it would be not far below zero – in the order of -0.5%. If the OCR reached that level, it's likely that the RBNZ would turn its focus to other unconventional measures.

The next option would be large-scale asset purchases, also known as quantitative easing (QE). This would involve the RBNZ creating new reserves – metaphorically 'printing money' – and using them to buy long-term bonds from the government or the private sector. By creating additional demand for these bonds, this would drive down longer-term interest rates.

QE is theoretically open-ended because the RBNZ can create unlimited reserves; the constraint is more likely to be one of willingness. Overseas central banks have been wary of pushing QE too far, due to concerns about overstimulating the economy or encouraging excessive risk-taking, or due to political opposition. As a result they appear to have erred on the side of doing too little, and inflation has tended to remain below target. But the evidence suggests that QE itself is effective when used sufficiently.

An important point about QE is that in the New Zealand context, much of its impact would be through the exchange rate. Low government debt and a relatively underdeveloped corporate bond market means that the pool of domestic assets is limited. As the RBNZ buys up the available bonds, the sellers will be left with cash to invest somewhere else. That cash may be used to buy foreign assets, and the resulting outflow of funds would put downward pressure on the New Zealand dollar.

Actually, one form of QE would be for the RBNZ to create New Zealand dollar reserves and sell them in exchange for overseas bonds. This would amount to massive unsterilised exchange rate intervention, and the effect would be to reduce the exchange rate (or prevent it from rising if other central banks are also doing QE).

The RBNZ could also choose to intervene in the swaps market, rather than the bond market. Swaps are essentially bets on where short-term interest rates will go in the future. They are derivative contracts, where no money changes hands initially, but they still have a big influence on fixed mortgage rates and other long-term interest rates. The RBNZ could 'bet' that interest rates are going to stay low for a long time. That wouldn't affect the supply of money, but it would still push longer-term interest rates down. One key advantage is that unlike bond purchases, this wouldn't be limited by the size of the local market.

Another option for the RBNZ is to lend directly to banks at low interest rates. This would create a significant risk exposure for the RBNZ, and as such we see it as something that might be used in a crisis management situation, rather than in the normal operation of monetary policy.

Economic and financial forecasts.

New Zealand forecasts

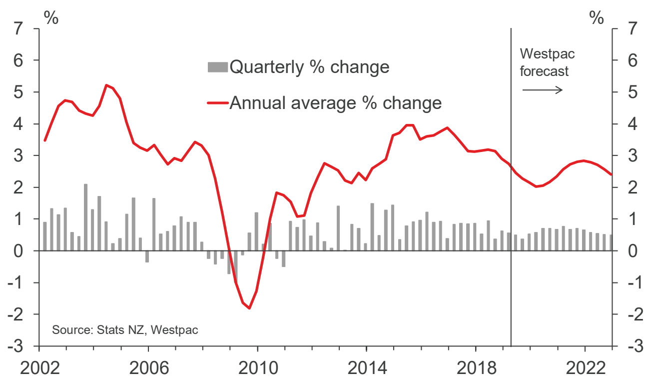
GDP components	Quarterly % change				Annual average % change			
	Mar-19	Jun-19	Sep-19	Dec-19	2018	2019	2020	2021
GDP (production)	0.6	0.5	0.4	0.5	2.9	2.1	2.3	2.8
Private consumption	0.4	0.3	0.6	0.7	3.2	2.6	2.9	3.8
Government consumption	0.9	0.9	0.9	0.9	1.9	2.8	3.6	3.6
Residential investment	2.7	3.0	2.5	1.5	2.6	8.8	3.9	-2.3
Business investment	1.9	-2.7	-0.6	0.0	4.0	-0.7	1.3	3.4
Stocks (% contribution)	-0.8	0.5	0.2	0.1	0.4	-0.4	0.1	-0.1
Exports	2.8	-1.5	-1.1	-0.3	3.1	2.4	-0.3	2.4
Imports	0.7	-1.0	0.2	0.5	5.7	0.0	2.3	3.6
Economic indicators	**Quarterly % change**				**Annual % change**			
	Mar-19	Jun-19	Sep-19	Dec-19	2018	2019	2020	2021
Consumer price index	0.1	0.6	0.6	0.3	1.9	1.6	1.7	1.8
Employment change	-0.1	0.8	0.2	0.4	2.3	1.3	1.8	2.0
Unemployment rate (end of period)	4.2	3.9	4.1	4.2	4.3	4.2	4.2	3.8
Labour cost index (all sectors)	0.4	0.7	0.6	0.6	1.9	2.3	2.4	2.5
Current account balance (% of GDP)	-3.6	-3.4	-3.3	-3.2	-3.8	-3.2	-2.9	-2.7
Terms of trade	0.9	1.0	-0.8	-0.9	-4.8	0.2	0.3	1.0
House price index	0.0	-0.5	0.5	1.1	2.8	1.1	7.5	7.6
Financial forecasts	**End of quarter**				**End of year**			
	Mar-19	Jun-19	Sep-19	Dec-19	2018	2019	2020	2021
90 day bank bill	1.85	1.73	1.00	0.90	1.87	0.90	0.90	0.90
5 year swap	2.04	1.66	1.10	1.00	2.40	1.00	1.15	1.40
TWI	74.0	72.7	71.9	72.2	73.5	72.2	71.1	71.7
NZD/USD	0.68	0.66	0.64	0.64	0.67	0.64	0.64	0.67
NZD/AUD	0.96	0.95	0.96	0.96	0.93	0.96	0.96	0.93
NZD/EUR	0.60	0.59	0.59	0.59	0.59	0.59	0.58	0.58
NZD/GBP	0.52	0.52	0.54	0.54	0.52	0.54	0.51	0.50

International economic forecasts

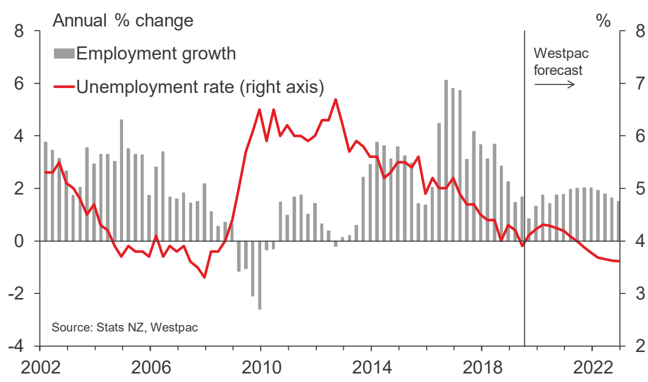
Real GDP (calendar years)	Annual average % change					
	2015	2016	2017	2018	2019f	2020f
New Zealand	3.5	3.9	3.1	2.9	2.1	2.3
Australia	2.5	2.8	2.4	2.8	1.8	2.4
China	6.9	6.7	6.8	6.6	6.1	5.8
United States	2.9	1.6	2.2	2.9	2.3	1.7
Japan	1.2	0.6	1.9	0.8	0.7	0.3
East Asia ex China	3.8	4.0	4.6	4.3	3.8	4.0
India	8.0	8.2	7.2	7.1	7.0	6.9
Euro Zone	2.1	2.0	2.4	1.8	1.1	1.2
United Kingdom	2.3	1.8	1.8	1.4	1.2	1.4
NZ trading partners	3.8	3.6	4.0	4.0	3.4	3.4
World	3.4	3.4	3.8	3.6	3.2	3.3

The economy in six charts.

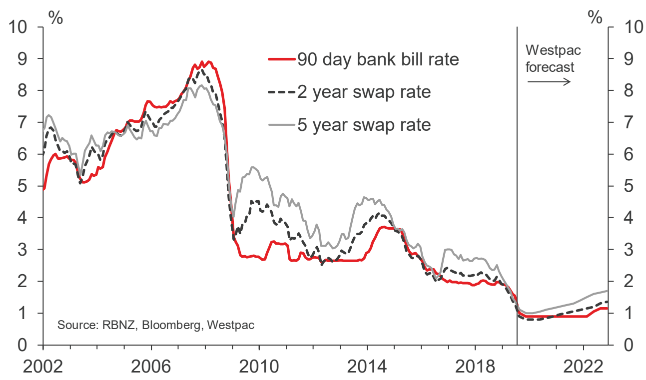
New Zealand GDP growth



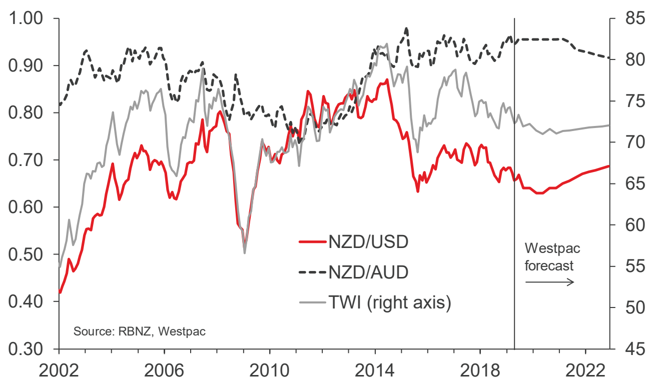
New Zealand employment and unemployment



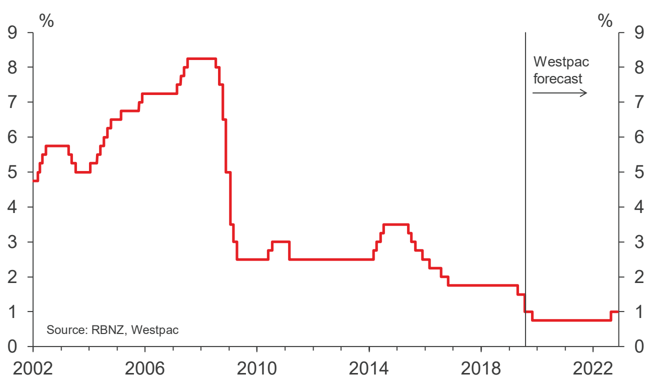
90 day bank bills, 2 year swap and 5 year swap rates



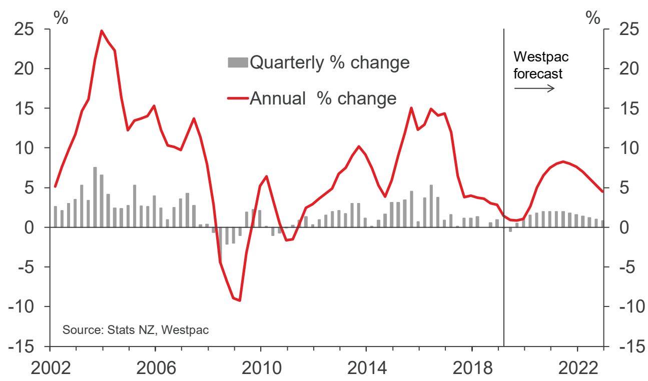
Exchange rates



Official Cash Rate



New Zealand house prices



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Past performance is not a reliable indicator of future performance. The forecasts given in this document are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

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